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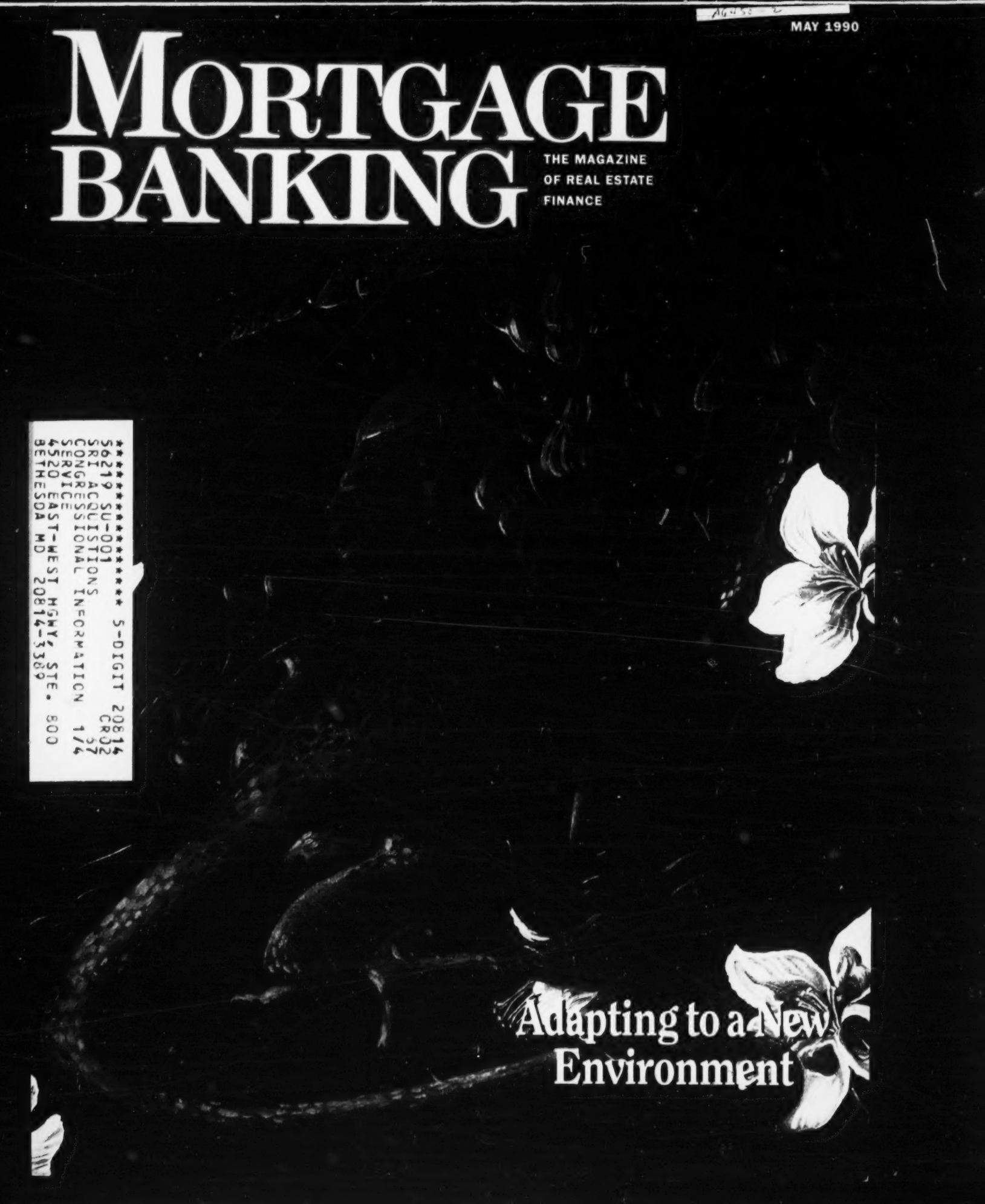

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Adapting to a New Environment

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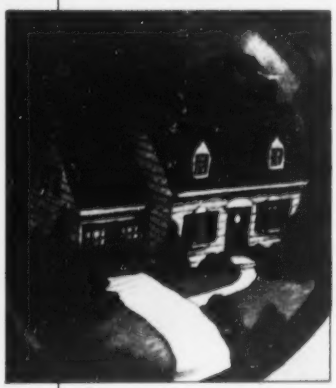
Secondary Mortgage Market



The closing of the decade caught the secondary markets in the midst of visible change. Today's sellers of mortgage-backed securities were yesterday's major buyers. These new-found sellers—thrifts in search of regulatory capital—dropped their MBS holdings by $50 billion in 1989 by Moody's count. Commercial banks are wearing new colors too as heavy buyers of mortgage securities. While on the CMO front, the agencies leapfrogged all other issuers last year to claim an 85 percent market stake versus 34 percent in 1989. All in all, it's a changed environment.

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COVER ILLUSTRATION BY JEANNE TURNER

Secondary Tremblers

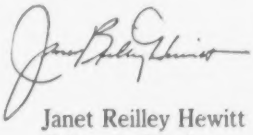
The secondary market was hit by powerful external forces last year. The result was huge shifts—both up and down—in the numbers that serve as a proxy for the market's activity.

The Richter scale registered some big surges in volume—whole loan CMOs for example tripled in volume last year. On the downward slope, senior/subs tumbled by 40 percent at last year's final quarter compared with their dominant presence in pass-through deals in 1988.

Even a real quake rocked the secondary in October. San Mateo-based Bay View Federal Savings & Loan Association had its triple-A rated, commercial mortgage-backed securities placed on a watchlist by Moody's for possible downgrade. The damage to collateral from the "act of God" was deemed insignificant by Moody's and the rating was reaffirmed.

But a real fundamental shifting of the foundation of the secondary market contributed to the controlled upheaval that shook the MBS markets last year. On top of an actual quake of major proportions, a symbolic quake rocked Wall Street when a major brokerage firm, with substantial mortgage securities dealings, went under. The fall of Drexel clinched these times as uniquely risky and prone to precipitous shifts in fortune.

A quick look at some numbers tells at least part of the story. The combined, single-class MBS issuance out of GNMA, Fannie Mae and Freddie Mac rose $50 billion last year versus 1988. That was a jump of 33 percent. Ninety-eight percent of that came from Fannie Mae and Freddie Mac. So, clearly the agencies benefited from the change rumbling through the market. Some big buyers of those conventional MBS were banks. In 1989's third quarter alone, banks boosted their holdings of MBS by 20.4 percent, HUD says. Risk-based capital rules proved a major force driving securitization volume. However, two apparent losers in the MBS market last year were U.S. investment banks and the U.K. secondary market, by Moody's reckoning anyway. CMO issuance by investment banks dropped by 69 percent last year versus 1988 volume. And mortgage-backed notes posted a zero growth year in the U.K. largely due to depressed originations tied to high interest rates. Looking ahead, this year will be hard pressed to measure up.



Janet Reilley Hewitt
Editor in Chief

Coming in June

An eye-opener on foreclosure and delinquency trends will be the lead piece in the June servicing issue. For those of you who think current problem loan rates are incredibly high compared to historical norms—you're right. Our lead story tells us that the number of loans in foreclosure rose 590 percent from 1965 to 1989.

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Mortgage Prepayments Slow to a Crawl

Steadily declining prepayments are likely to continue at a snail's pace as a fall off in first-time homebuyers begins to take hold.

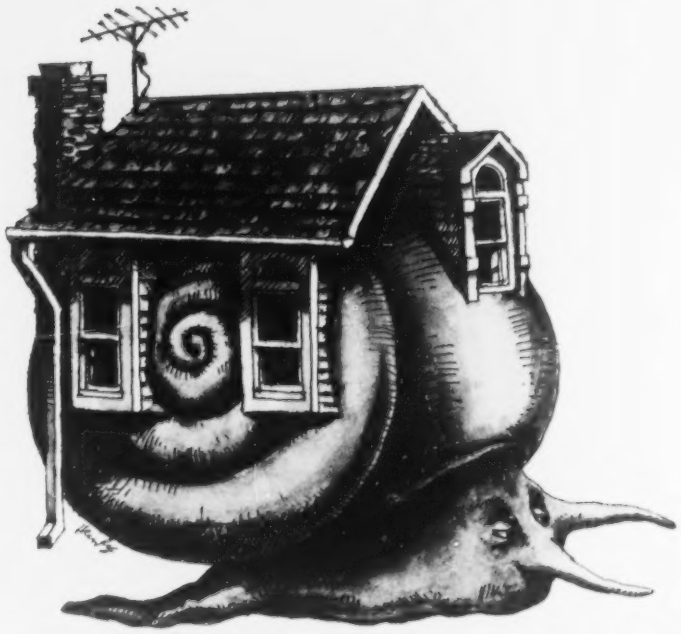


ILLUSTRATION BY JOHN HEINLY

Prepayment rates of Freddie Mac and Fannie Mae pass-throughs have declined steadily since 1986, because of diminished housing demand, reduced home price inflation and weakening demographics. Pools backed by conventional mortgages originated since 1985 are paying down even more slowly than those made up of older loans written in the 1970s. We expect that a falloff in the number of first-time homebuyers will accentuate the slowing prepayment trend in the 1990s.

The mortgage securities market, however, has not fully adjusted to this prepayment shift—the prices of many sectors still reflect the faster prepayments seen a few years ago.

Prepayment rates since 1986 are summarized in Figure 1. They are expressed as percentages of the Public Securities Association standard prepayment model (PSA), for "old" Freddie Mac and Fannie Mae 8s, 9s and 10s. These pools have remaining weighted-average maturities (WAMs) of 22 years or less and are made up of conventional mortgages originated in the 1970s. The prepayment rates of these older pass-throughs have fallen steadily during the 1986-89 period. Prepayment rates of the other coupons have declined comparably.

Rising interest rates since 1987 account for some of the slowdown in these prepayment rates. However, the magnitude of the fall off cannot be explained by interest rate movements alone. Even adjusting for interest rate levels, prepayment rates of these securities have slowed steadily since 1986. (We focus in this report on the decline of Freddie Mac/Fannie Mae prepayment rates. GNMA prepayments also have slowed during the past few years, but to a much smaller degree. We can speculate that shifts in the economic forces fueling housing activity, such as reduced home price inflation, have less impact on moderate income FHA/VA borrowers than they do on conventional mortgage borrowers.)

Moderately seasoned securities

The interest rate path of the past decade created two distinct segments of 8 percent to 10 percent mortgage pass-through securities: those backed by loans originated in the 1970s, and those made up of loans written since 1985.

As illustrated in Figure 2, the amount outstanding of the newer issues has grown rapidly and now exceeds that of older pass-throughs. "Moderately seasoned pass-throughs"—those issued since 1985 that are now at least two years-old—also now surpass in volume the amount of older pools.

As shown in Figure 3, the moderately seasoned pass-throughs are paying off even more slowly than the older securities. During the past two years, the prepayment rates of moderately seasoned Freddie Mac/Fannie Mae 8s, 9s and 10s have been 9 percent to 37 percent PSA slower than those of their older counterparts. Moderately seasoned 9s, for instance, prepaid at only

Ravi Mattu, Mark Gordon and Michael Waldman

126 percent PSA during 1988 and 1989, compared with 163 percent PSA and 145 percent PSA for old 9s. These differences, however, appear to be narrowing with time. Based on recent prepayment experience, our projections for the moderately seasoned securities are about 20 percent PSA slower than for the old pass-throughs.

The slower prepayments of the moderately seasoned issues are of special significance because these securities represent the majority of the seasoned pass-throughs that are traded. Furthermore, moderately seasoned pass-throughs back essentially all interest-only and principal-only STRIPs collateralized by conventional mortgages.

Several factors have led to the slowdown in prepayments since 1986. The pent-up demand for housing caused by the high interest rate environment of the early 1980s was substantially satisfied during the 1984-1987 period. Because of high mortgage rates, housing starts plunged from an annual rate of 2 million units in 1978 to 1.1 million units in 1982. As mortgage rates subsequently declined, housing starts recovered and averaged 1.7 million units during the 1984-1987 period, before gradually falling to an estimated level of 1.4 million units in 1989.

Slower home price appreciation has reduced housing market activity—homeowners are less eager to trade up to larger homes if they do not expect to realize profits on their housing investments. The average price of existing homes sold increased by only 4.3 percent in 1989, after rising at annual rates of 6.3 percent in 1986-87 and 9.9 percent during the 1970s, according to the National Association of Realtors. Soft housing prices in many markets nationwide at present will further deter activity.

FIGURE 1

PSA Prepayment Rates of Old Freddie Mac/Fannie Mae Pass-Throughs, 1986-89[a]

Year	Average Current-Coupon FHLMC Yield[b]	Coupon 8%	9%	10%
1986	10.19%	160%	192%	265%
1987	9.39	169	210	340
1988	10.17	134	163	208
1989	10.32	119	145	177

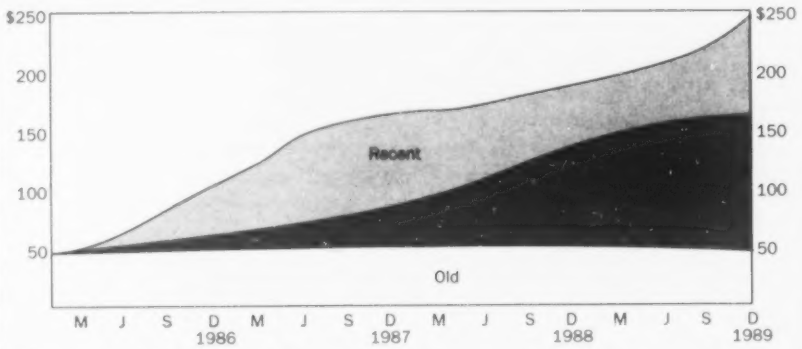
[a] Thirty-year conventional mortgage pools with current WAMs of 22 years or less.
[b] Lagged three months.

The prepayment difference between old and moderately seasoned pass-throughs is partly explained by the impact of ARM financing. Homeowners who are relatively mobile were attracted to ARMs in large numbers beginning in 1982. The corresponding population of fixed-rate mortgage borrowers has been less likely to move, and mortgages of these homeowners have exhibited slower prepayments. This phenomenon should not affect the prepayments of the older mortgages, which were originated before the advent of the ARMs market.

Another reason for the difference is the greater accumulated equity in the homes that were purchased in the 1970s, compared with those bought since 1985. Equity buildup promotes mortgage turnover by providing down payments for new home purchases and by enabling prepayments for cash take out refinancings.

Figure 2

Freddie Mac/Fannie Mae 8%-10% Pass-throughs Outstanding 1986-89 (Dollars in Billions)[a]



[a] Thirty-year conventional mortgage pools.
Recent: WAM between 28 years and 30 years.
Mod. Seasoned: WAM between 22 years and 28 years.
Old: WAM less than 22 years.

FIGURE 3

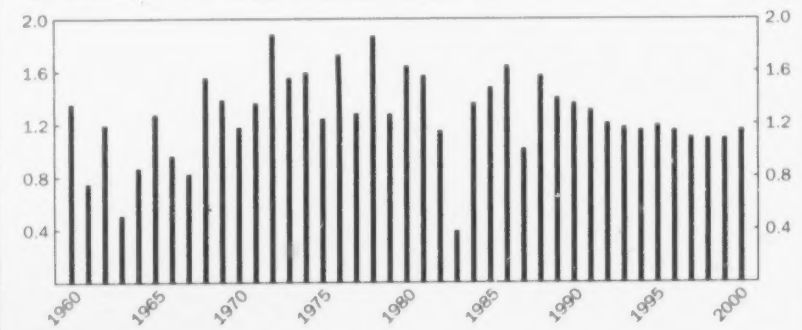
PSA Prepayment Rates of Old and Moderately Seasoned Freddie Mac/Fannie Mae Pass-Throughs

Year	8% Old	8% Mod. Seas.	8% Diff.	9% Old	9% Mod. Seas.	9% Diff.	10% Old	10% Mod. Seas.	10% Diff.
1987	169%	112%	57%	210%	113%	97%	340%	312%	28%
1988	134	112	22	163	126	37	208	179	29
1989	119	110	9	145	126	19	177	152	25

Old: WAM less than 22 years.
Mod. Seasoned: WAM between 22 and 28 years.

Figure 4

Number of Household Formations, 1960-2000 (in Millions)



Source: Census Bureau, U.S. Department of Commerce.

Declining housing turnover

Throughout the rest of this century, demographic forces should continue to moderate housing turnover. The number of first-time homebuyers is expected to fall during the 1990s as the number of households headed by 25 to 34 year-olds declines by more than four million. Figure 4 shows the annual increase in households since 1960, with Census Bureau projections through the year 2000. After factoring in immigration, total household growth is projected to slow from an annual rate of 1.6 million in 1988 to 1.2 million by the year 2000.

At the same time, the population will shift toward an older age group. The percentage of households headed by people under the age of 35 is expected to decline from 29 percent in 1985 to 20 percent in 1990, while households headed by the 35 to 54 year-olds will increase from 35 percent to 44 percent. Ordinarily, these older families bolster housing activity by trading up to larger, more expensive homes. This process, however, will be limited by the lack of entry-level home buyers.

Migration levels between states should moderate

The 1980s witnessed high levels of migration between states. In addition to the long-term trend of population movement from the Northeast and Midwest to the sun belt, economic disruptions increased the levels of migration. The energy boom in Texas coincided with the severe recession in the industrial Midwest and led to a doubling of migration into Texas during the early 1980s. The oil bust that followed in 1984 and the industrial recovery in the Midwest reversed this trend in the mid- and late 1980s.

The Census Bureau and The Joint Center for Housing Studies also provide longer-term projections for the rest of this century. These long-term projections, while tentative, point toward declining inter-migration between states. All of this data supports the conclusion that slower prepayment rates are likely to be a hallmark of the 1990s. **MB**

Michael Waldman is a managing director, and Ravi Mattu and Mark Gordon are directors in Salomon Brothers' BPA-mortgage department in New York.

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